In the Supreme Court of the United States

OCTOBER TERM, 1974

No. 74-1017

NATHAN AND JOANNE T. CUMMINGS, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

MEMORANDUM FOR THE RESPONDENT IN OPPOSITION

The sole question raised by the petition is whether the court of appeals correctly held that a payment made by petitioner, Nathan Cummings,[1] to a corporation of which he was a director, pursuant to an asserted liability under Section 16(b) of the Securities Exchange Act of 1934, should be treated as a long-term capital loss, where the payment arose from a series of transactions in which petitioner had realized a long-term capital gain.

1. Petitioner was a director of Metro-Goldwyn-Mayer, Inc. In April, 1961, petitioner sold 3,400 shares of MGM stock upon which he realized and reported a long-term capital gain. During September and October, 1961, petitioner purchased 3,000 shares of MGM stock for a total of $146,960.89. Since this purchase was within six months of his previous sale, the provisions of Section 16(b) of the Securities Exchange Act of 1934, 15 U.S.C. 78p(b),

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[1]Joanne T. Cummings is a party solely because she filed a joint return with her husband for the year at issue.

became applicable, producing "insider's profit" of $53,870.81, which was recoverable by MGM (Pet. App. A-19).

Upon review of MGM's proxy solicitation material for its annual stockholders meeting on February 23, 1962, the Securities and Exchange Commission informed MGM that if petitioner had realized material profits from his sale and purchase, that fact would have to be noted in the proxy statement. In January, 1962, petitioner decided to remit the $53,870.81 to MGM, although he contended at that time that any alleged violation of Section 16(b) was inadvertent (Pet. App. A-19).

Petitioner treated this payment as a deduction against ordinary income on his 1962 income tax return. On audit, the Commissioner concluded that the payment was deductible as a long-term capital loss and determined a deficiency of $45,790.18. The Tax Court upheld petitioner's contention that the payment was an ordinary and necessary business expense, based upon its view that petitioner made the payment to protect his business reputation (Pet. App. A-1 to A-9). After the reversal of a similar Tax Court decision in *Anderson* v. *Commissioner*, 480 F.2d 1304 (C.A. 7), reversing 56 T.C. 1370, the Tax Court reconsidered the case, but reaffirmed its original decision, with six dissents (Pet. App. A-10 to A-16). The court of appeals reversed, holding that the payment was deductible as a long-term capital loss (Pet. App. A-17 to A-29).

2. In holding that petitioner's payment to MGM pursuant to Section 16(b) of the Securities Exchange Act of 1934, as a result of insider trading upon which he realized long-term capital gain, must be treated as a long-term capital loss, the decision below correctly recognized that this Court's decision in *Arrowsmith* v. *Commissioner*, 344 U.S. 6, requires such a result. This conclusion is in harmony with the two other circuits which have ruled on this question. See *Mitchell* v.

Commissioner, 428 F.2d 259 (C.A. 6), certiorari denied, 401 U.S. 909; and *Anderson* v. *Commissioner*, 480 F.2d 1304 (C.A. 7).

In *Arrowsmith*, the taxpayer received liquidating distributions from a corporation which were taxable as capital gains. Subsequently, as a transferee, he was required to relinquish the liquidating distribution in order to satisfy a judgment against the dissolved corporation and claimed an ordinary loss deduction for the payment. However, this Court held that the shareholder's payment could be deducted only as a capital loss because it arose solely from the prior liquidation from which capital gain had been realized. The tax treatment of the payment was linked to the tax treatment of the original receipt upon which the payment was based. In *United States* v. *Skelly Oil Co.*, 394 U.S. 678, 685, the Court explained the *Arrowsmith* rule as follows:

> The rationale for the *Arrowsmith* rule is easy to see; if money was taxed at a special lower rate when received, the taxpayer would be accorded an unfair tax windfall if repayments were generally deductible from receipts taxable at the higher rate applicable to ordinary income. The Court in *Arrowsmith* was unwilling to infer that Congress intended such a result.

The decision below correctly held, as did the Sixth and Seventh Circuits, that the *Arrowsmith* rule is fully applicable to a payment of "insider profits" under Section 16(b) of the Securities Exchange Act of 1934. Here, petitioner's original gain was taxable at the preferential capital gains rates. If his payment under Section 16(b) to the corporation was deductible against ordinary income, he would receive an unwarranted windfall. As the Sixth Circuit observed in *Mitchell* v. *Commissioner*, *supra*, 428 F.2d at 263:

> Under *Arrowsmith* and *Skelly Oil*, when income is given up, which in its inception was taxed at reduced rates, the taxpayer is not permitted to enjoy preferred treatment twice by deducting in full the extra amount given up as an ordinary deduction.

Accord: *Anderson* v. *Commissioner, supra*, 480 F.2d at 1307.

In holding that payments under Section 16(b) are deductible as ordinary and necessary business expenses, the Tax Court has stated that when such payments are made by the insider for reasons related to his trade or business, they are deductible as a business expense. This view, which has now been rejected by each of the three circuits that have considered the question, gives controlling significance to the alleged business purpose of the payment. As the court below noted (Pet. App. A-25, n. 9), however, virtually every person who repays his insider profits could claim that he did so to protect his business reputation.

The motives for such payments are irrelevant in triggering the applicability of Section 16(b). That statute depends solely on the objective fact of a short-swing transaction. See, *e.g.*, *Reliance Electric Co.* v. *Emerson Electric Co.*, 404 U.S. 418, 422; *Smolowe* v. *Delendo Corp.*, 136 F.2d 231, 235-237 (C.A. 2), certiorari denied, 320 U.S. 751. Such motives should be similarly irrelevant in determining the tax consequences of such payments. Once it is recognized that a Section 16(b) payment is a disbursement of an amount previously taken into income as a capital gain, the rule of *Arrowsmith* requires that the deduction must assume the tax character of the gain that was originally taken into income. The payment is therefore deductible only as a long-term capital loss.

3. Petitioners argue (Pet. 12-13) that even if the Section 16(b) liability is conceded,[2] there is no justification for denying deductibility on the ground of public policy. But petitioner has not been denied a deduction on that ground.[3] The Commissioner has conceded that Section 16(b) payments are deductible, but only in the same manner as the original gain was taxed. See Rev. Rul. 61-115, 1961-1 Cum. Bull. 46. The only question is whether the deduction for the Section 16(b) payment should offset ordinary income or capital gains.

Nor has the decision below determined the tax character of the deduction on the basis of the public policy underlying Section 16(b). To the contrary, in conformity with the prior appellate decisions in *Mitchell* and *Anderson*, the court of appeals applied the *Arrowsmith* rule in concluding that petitioner was limited to a long-term capital loss deduction.

It is respectfully submitted that the petition for a writ of certiorari should be denied.

ROBERT H. BORK,
Solicitor General.

MARCH 1975.

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[2]Petitioner argues (Pet. 11-12) that to deny deductibility on the grounds that he might have violated Section 16(b) constitutes a denial of the due process. But given the fact that a payment was made by petitioner to settle a claim of Section 16(b) liability, some tax characterization is necessary at this time whether or not a formal adjudication of this liability has been made. On advice of its independent counsel, MGM refused to refund the payment as petitioner requested (Pet. App. A-20, n. 3).

[3]Petitioners invoke (Pet. 12) the decisions in *Tank Truck Rentals* v. *Commissioner*, 356 U.S. 30, and *Commissioner* v. *Tellier*, 383 U.S. 687. The issue in those cases was whether any deduction of certain payments was barred by public policy, not whether a payment was deductible against ordinary income or capital gains.